No. 15,105

United States Court of Appeals

For the Ninth Circuit

PALO ALTO MUTUAL SAVINGS AND LOAN ASSOCIATION,

Appellant,

vs.

RALPH E. WILLIAMS, Trustee of the Estate of John E. Duskin, Jr., formerly doing business as John E. Duskin, Jr., General Contractor, Bankrupt,

Appellee.

Appeal from the United States District Court for the Northern District of California, Southern Division.

APPELLANT'S REPLY BRIEF.

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INTRODUCTION.

In synopsizing our statement of facts, Appellee leaves out several important factors: Notably, that the security by its terms includes interest until principal is repaid, that Appellant is a savings and loan association, and that the loan was for construction of an improvement and all funds were so used to directly enhance the value of the security. Appellee's omission

of these facts was undoubtedly due to a desire for brevity rather than to an intentional oversight.

Appellee's statement of the question would be proper were it not for the use of the term "equitable reasons" in *Beecher v. Leavenworth State Bank,* 192 F. 2d 10. Because of the uncertainty of that term we feel a true statement of the question presented should include certain major differentiating factors of the case at hand. Hence our General Question (Appellant's Brief, page 4) and our Specific Question (Appellant's Brief, page 51).

Our reply to more specific points now follows.

REPLY ARGUMENT.

In answering our opening brief, Appellee cites and argues four Supreme Court cases (pages 3 to 10 inclusive) assumedly dealing with our question, but with a discussion so intermingled with excerpts from district Court opinions and old English writings that it is difficult to discover just what those Supreme Court cases held. To clarify, the Supreme Court cases cited by Appellee are as follows:

Coder v. Arts, 213 U.S. 223, 53 L.Ed. 772 (1908);

Sexton v. Dreyfus, 219 U.S. 339, 55 L.Ed. 244 (1911);

Vanston Bondholders Protective Committee v. Green, 329 U.S. 156, 91 L.Ed. 162 (1946);

City of New York v. Saper, 336 U.S. 328, 93 L.Ed. 710 (1948).

Initially, Appellee does not mention *Louisville Joint Stock Land Bank v. Radford,* 295 U.S. 555, 79 L.Ed. 162 (1935), noted in our opening brief at pages 8 and 9 and holding that the rule denying post-bankruptcy interest

> " . . . has no application when the mortgage has a preferred claim against proceeds realized by the trustee from a sale of the security free of liens."

Nonetheless, of these four Supreme Court decisions they do cite, only one, the *Vanston* case, deals with whether simple post-bankruptcy interest is allowed on a sale free and clear of liens in an otherwise insolvent estate. That case *did* allow it. (Appellant's opening brief, page 9).

Coder v. Arts was a case where the estate was *fully solvent,* and is excellent authority for a proposition not involved here. The *Sexton* case, where sales proceeds were *not* sufficient, has already been discussed. *City of New York v. Saper,* was an *unsecured* claim case for State franchise and unemployment insurance taxes, rightfully applied the unsecured creditor rule.

Appellee does not deny that the *Vanston* and *Louisville Joint Stock* cases do stand for allowing simple post-bankruptcy interest from otherwise insolvent estates where there is a sale free and clear and sufficient proceeds. Thus Appellee's general statement (Appellee's brief, page 9) that the Supreme Court has not ruled on this question is in error.

Appellee's next point is a discussion of 9th Circuit decisions, notably the *Beecher* case. None of it an-

swers the points set forth in our opening brief and it would be superfluous to repeat them again. Significant that Appellee lists two pages of sentences from the *Beecher* decision (Appellee's brief, pages 12, 13) as reasons for a rule that is inapplicable to the case at hand. Significant too, that they admit the *Beecher* case gives *no* indication of whether the security was worth more or less than the claims.

[The *Vanston* case and *Pacific States Corp. v. Hall* 166 F. 2d 688, both cited in *Beecher,* turned on this particular point (Appellant's opening brief, pages 14, 15)].

A security can have "proceeds" in two different ways. It can be sold, changing the whole property immediately to dollars. Or it can be held in investment and itself produce interest, rental, dividends or other income.

There was no sale of the security in the *Beecher* case. There being none, the Court specifically held that if it yielded proceeds in the *other* fashion by being income producing, that unqualifiedly these proceeds should be applied on post-bankruptcy interest.

Is there so basic a difference between the two means of yielding proceeds that in one case it is equitable to apply them on post-bankruptcy interest and in the other it is not, the proceeds in each case being sufficient? We think not.

Next, Appellee discusses some of the cases cited by Appellants on this question from the other 10 circuits, pointing out that several are not precisely on point.

Note carefully that Appellee does not cite *even one* circuit Court decision from *any other circuit* in which post-bankruptcy interest was *not* allowed in this type of secured claim case. Uniformly, following the *Vanston* and *Louisville Stock Bank* Supreme Court decisions, all other circuits allow it. The only "confusion and difference of opinion" (Appellee's reply brief, page 21) is correlating the *Beecher* case with the other circuit Court decisions in the 9th Circuit, with the two Supreme Court decisions on the point, and with Circuit decisions from all other circuits.

Prior to replying to Appellee's designation of "Equitable Principles", it is better to clarify that with which we are dealing. We are dealing first with a *secured* claim. We are *transferring the lien of that security* to the money proceeds of its sale. And we are *not in any way affecting general creditors,* since the sales proceeds are in no event sufficient to create a surplus for them regardless of whether or not the Appellant is allowed post-bankruptcy interest.

Appellee does not argue with the proposition that where the lien includes interest to date of payment, that lien is *not lessened* on attaching to the proceeds. Even the Bankruptcy Act (Section 57 (h)) specifically directs how this be done. Appellee does argue, however, that we should destroy the lien as to part of what it secures on the ground of doing "equity".

The practical side of the entire question then becomes important, especially in view of Appellee's spurious argument (Appellee's reply brief, page 19)

that Appellant would have had "additional costs" and "might have suffered losses" had not a sale free and clear of liens been made.

The power to sell free and clear of liens is not created by statute, but is an implied power to be used by the bankruptcy Court in the exercise of sound discretion.

As stated in 8 *Corpus Juris Secundum* at 1041 and 1042 (Sec. 311, (a)):

> "The power to sell free and clear should be exercised sparingly; and the court must be satisfied, before it will order such a sale, that that course will advance the interests of the general creditors, and will not injuriously affect the interests of creditors holding liens on the property. According to the settled practice, the trustee should not be directed to take possession of the property and sell it if the liens equal the value of the property or if the property is encumbered to an amount exceeding its value, except on the request or with the consent of the lienholders. Nevertheless, the court has power to order a sale of property free of liens regardless of whether there was any equity in it for unsecured creditors, especially where the lienholders did not apply for leave to foreclose and the trustee did not petition to surrender the property as burdensome; and the sale may be ordered either with or without the consent of the lienholder."

The immediate conclusion is that where the property value is equal to or less than the total of the liens against it, bankruptcy Courts should allow foreclosure proceedings to continue under State law because in

neither event will any equity result for general creditors. This removes a burden from bankruptcy administration and in no way affects the rights and priorities existing and well known to all secured creditors at the time of obtaining their respective securities. Each junior lien claimant knows at the time of obtaining his security that it is subordinate to principal, interest and costs of foreclosure of each and every security superior to his. He gets exactly that for which he bargained. A far cry from the unsecured creditor, who also bargains for payment in full but gets only the debtor's ability and willingness to pay, with never any assurance of priority.

Building and loan associations loan only on first securities and always loan an amount less than the value of the property securing the same. Sound business judgment dictates this, State and Federal laws require it. On foreclosure they are either paid principal, interest and costs in full or take in the property itself free of all subordinate liens. In either event they have hardly suffered "losses" that Appellee would have this Court believe they are saving us from by sales free and clear.

It is common knowledge that for many years foreclosure proceedings have been allowed to proceed outside of bankruptcy where general creditors were unaffected and secured creditors got their orginally bargained-for returns. There are two reasons why in recent times in this 9th Circuit this is not occurring so frequently.

First, the bankruptcy Court still has *power* to order a sale free and clear in bankruptcy regardless of

whether there is any equity resulting from unsecured creditors, even where the lienholders don't consent (8 *C.J.S.,* Sec. 311, supra). Secondly, where the sale is made within bankruptcy proceedings a 5% "commission" is allowed to be taken out of the proceeds by the bankruptcy Court. This latter of course is not available if foreclosure is allowed to be conducted outside of bankruptcy under State law.

The net effect is this: Where a debtor defaults under a first security, if he is not bankrupt, the first security holder gets what would amount to post-bankruptcy interest; if he is bankrupt and the foreclosure is allowed to proceed outside of bankruptcy again, the creditor gets what would amount to post-bankruptcy interest; if the sale is conducted in bankruptcy but subject to liens, the creditor still gets what amounts to post-bankruptcy interest; but if the foreclosure is carried on in bankruptcy by a sale free and clear the first secured creditor doesn't get post-bankruptcy interest, rather the next junior encumbrancer gets an amount equal to it, and the 5% fee is skimmed off the top. In none of the above four situations is the unsecured creditor affected.

We fail to see where any "equity" arises in the fourth situation above cited to warrant the abrogation of an established lien right. On the contrary, as in *Wilson v. Dewey,* 133 F. 2d 692 where this precise question arose, the only equitable as well as legal thing to do is to allow post-bankruptcy interest to all secured claimants in the order of their priority to the extent of sales proceeds and no further.

CONCLUSION.

In examining Appellee's reply brief, we note just prior to closing on page 21 that they say the "cases heretofore cited on this subject involve general unsecured creditors . . ." What is meant is that the cases *they* cite involve general unsecured creditors, for it is only in those cases that the post-bankruptcy interest stopping rule is announced and applied. They moreover admit that even in the *Beecher* case they

> ". . . cannot ascertain from the opinion whether the claims of Federal Land Bank of Spokane and of Leavenworth State Bank were secured at the time of the filing of the petition." (Appellee's reply brief, pages 11, 12).

The fact remains that all decisions cited involving *secured* creditors claims in this type of situation both in the Supreme and Circuit Courts do allow post-bankruptcy interest, and none disallow it. Sound logic and equity dictate that this rule should be followed in the 9th Circuit also, and that the District Courts order of February 13, 1956, should be reversed.

Dated, November 28, 1956.

Respectfully submitted,

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